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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,
Petitioner,

v.

AMERICAN COLLEGE OF PHYSICIANS,
Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Federal Circuit

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BRIEF FOR AMICUS CURIAE AMERICAN ASSOCIATION FOR THE ADVANCEMENT OF SCIENCE

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BRIEF FOR AMICUS CURIAE AMERICAN ASSOCIATION FOR THE ADVANCEMENT OF SCIENCE

PRELIMINARY STATEMENT

This brief is filed by American Association for the Advancement of Science, as amicus curiae, pursuant to the written consent of Petitioner and Respondent which are on file with the Court. American Association for the Advancement of Science ("AAAS") concurs in Respondent's formulation of the question presented in this litigation and concurs in the arguments, legal analysis and conclusions set forth in Respondent's

brief. AAAS's brief will primarily address the Government's assertion that a so-called blanket rule was adopted by Congress in the 1969 Tax Reform Act requiring the taxation of all commercial advertising revenues generated by professional journals published by exempt organizations.

INTEREST OF AMICUS CURIAE AMERICAN ASSOCIATION FOR THE ADVANCEMENT OF SCIENCE

AAAS was organized in 1848 and is exempt from tax under Section 501(c)(3) of the Internal Revenue Code of 1954.[1] AAAS's membership consists of professional scientists, educators and other persons having a technical background or interest in the areas of science. AAAS publishes a weekly journal entitled *Science*. Through the publication of *Science*, AAAS fulfills its corporate and exempt purpose of furthering the work of scientists and improving the effectiveness of science in the promotion of human welfare.

Science was founded by Thomas A. Edison in 1880. Alexander Graham Bell was one of its successor publishers. Since 1900, *Science* has been the official publication of AAAS. Its technically oriented articles are usually written by scholars and scientists, which have included over 140 Nobel Prize winners.[2] *Science* is a

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[1] 26 U.S.C. § 501(c)(3). All references to the Internal Revenue Code and regulations promulgated thereunder are to provisions effective in 1975, unless otherwise indicated.

[2] Judge Greene noted that scientists who write articles for *Science* "[a]re paid nothing for their contributions but consider it an honor to be accepted for publication." *American Association for the Advancement of Science* v. *The Hearst Corporation*, 498 F. Supp. 244, 248 (D.D.C. 1980).

unique source of technical scientific information, and it reports the results of experiments and developments in *all* fields of science. AAAS has strived to make *Science* a clearinghouse where scientific discovery and the equipment necessary to bring about such discoveries are identified and discussed. AAAS believes this synergy is necessary because without improvements in the tools of science there can be little scientific advancement. Advances in instrumentation frequently open new areas of scientific inquiry.

Like Respondent's publication, *Science* contains a limited amount of advertising of a highly technical nature. *Science's* advertisements educate the scientific community in the latest technical developments in the tools and equipment of science.[3] As early as 1895, *Science* expressly restricted its acceptance of advertising to that which is relevant and informative to the scientific community it serves. Advertisers understand that their advertisements must be informative rather than promotional and factual rather than testimonial. In keeping with its advertising policy, *Science's* advertisements contain substantial technical and performance information concerning the equipment and chemicals presented in the advertisements. These advertisements convey far more information regarding the various functions, adaptations, performance standards and technical specifications of the product involved than is customarily found in commercial advertisements in popular science magazines.

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[3] As noted by Judge Greene, advertisements in *Science* "[o]ffer laboratory equipment, chemical substances for experiments, and little else." *Id.* at 248.

In a recent technical advice memorandum,[4] the Internal Revenue Service held that *Science's* advertising revenues constituted income from an unrelated trade or business. The Court's decision in this case will have a direct and material impact on AAAS's continued ability to publish *Science*. Therefore, AAAS is submitting this brief to the Court in support of Respondent.

SUMMARY OF ARGUMENT

The Government, aided and abetted by commercial publishers, asks this Court to rule that Congress enacted a "per se" or "blanket" rule that all commercial advertising revenues of professional journals are subject to unrelated business income tax (Gov. Brf., pp. 27-28). The Government cites Example (7) of 1967 Treasury Regulations, Section 513(c) as enacted by the 1969 Tax Reform Act, selective portions of the Congressional Committee Reports and testimony at Congressional Hearings in support of its blanket rule (Gov. Brf., pp. 16, 22-27). The Government's analysis overlooks the plain language of Section 513(c), the applicable substantial relation test imposed and required by Section 513(a) and the applicable Regulations under Section 513. If the Government's argument is accepted, virtually no tax-exempt entities will be able to show that their advertising is substantially related to their exempt purposes, and some vitally important professional journals may be forced to cease publication. Congress could not have intended such a Draconian result.

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[4] LTR 8418002, dated December 26, 1983.

ARGUMENT

A. Section 513(a) Mandates That Journal Advertising Revenues Be Tested For Substantial Relation Before A Finding Of Unrelated Business Income Can Be Made.

Section 513(a) defines an "*unrelated* trade or business" as one which is not substantially related to the exempt purposes of a tax-exempt organization. The Treasury Regulations virtually repeat the statutory language in defining an *unrelated* trade or business. Treas. Reg. § 1.513-1(a).

In his message to Congress in 1950 concerning the adoption of the unrelated business income tax, President Truman stated:

> Responsible educational leaders share in the concern about the fact that an exemption intended to protect educational activities has been misused in a few instances to gain competitive advantage over private enterprise through the conduct of business and industrial operations *entirely unrelated* to educational activities. [Emphasis supplied.]

Hearings on Revenue Revision of 1950 Before Committee on Ways and Means, 81st Cong., 2d Sess. 4 (1950). Secretary of the Treasury Snyder echoed President Truman's remarks:

> These provisions [Sections 511-513] preserve the tax-free status of legitimate activities of educational and charitable organizations and, at the same time, correct the abuses which properly have received so much general condemnation.
>
> Business operations of charitable and educational institutions *clearly unrelated* to their exempt functions generally would be subjected to the regular corporation income tax.

Hearings on Revenue Revision of 1950 Before Senate Finance Committee, 81st Cong., 2d Sess. 6, 7 (1950).

Thus, the receipt of revenue by a tax-exempt organization should be subject to tax only if the activity generating the revenue is not substantially related to its exempt function. It is not the commercial nature of the activity which gives rise to tax, but, rather, it is the unrelatedness of the activity to the organization's exempt purposes which implements the tax. For example, no one can seriously contend that a tax-exempt hospital does not compete with a proprietary hospital in a commercial, business sense. Yet a tax-exempt hospital's receipt of fees for health care services is not unrelated business income since these services contribute importantly [i.e., are substantially related] to the purpose for which its exemption was granted. *See, e.g.*, S. Rep. No. 2375, 81st Cong., 2d Sess. 106-107 (1950).[5]

The emphasis on relatedness as a measure to determine whether commercial activities result in unrelated income is also mirrored in the Treasury Regulations. In commenting on what constitutes a trade or business, Treas. Reg. § 1.513-1(b) (1967) provides:

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[5] Similarly, a tax-exempt hospital's operation of a gift shop, frequented by patients, visitors of patients and its employees, does not constitute an unrelated trade or business. Rev. Rul. 69-267, 1969-1 C.B. 160. *See*, Rev. Rul. 69-268, 1969-1 C.B. 160 (tax-exempt hospital's operation of cafeteria primarily for its employees and medical staff not unrelated business) and Rev. Rul. 73-104, 1973-1 C.B. 263 (museum's sale to general public of greeting cards portraying its art works and the art works of other museums not unrelated business). Even though these activities are clearly commercial, profit-motivated activities, the Internal Revenue Service held that the activities contributed importantly to each organization's exempt purposes and, hence, were not subject to tax.

> In general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute 'trade or business' within the meaning of section 162—*and which, in addition, is not substantially related to the performance of exempt functions*—presents sufficient likelihood of unfair competition to be within the policy of the tax. [Emphasis supplied.]

This theme is continued later in the Treasury Regulations. In defining whether a commercial activity is substantially related, Treas. Reg. §§ 1.513-1(d)(1) and (2) (1967) provide that the commercial activity in question must be compared to the exempt purposes furthered by the activity. Equally important, this determination is not to be made by a blanket rule; rather, it "depends *in each case* upon the facts and circumstances involved." [Emphasis supplied.]

This statutory and regulatory framework has been part of our law for 35 years and mandates that commercial activities of a tax-exempt organization be tested on a case-by-case basis for substantial relation to determine whether the income from the activity results in unrelated business income.

B. Section 513(c) Did Not Preempt The Substantial Relation Test But Merely Allowed Commercial Activities Of A Tax-Exempt Organization To Be Segmented.

Elaborating on the term *trade or business,* Section 513(c) as enacted by the 1969 Tax Reform Act provided that a commercial activity conducted by an exempt organization will not lose its status as a *trade or business* merely because the activity is carried on

within a larger aggregate of exempt functions.[6] It does not say that a commercial activity will *ipso facto* lose its identity as a *related* trade or business. Section 513 (c) does not override, or even speak to, the issue of determining whether a fragmented commercial activity is substantially related to an organization's exempt functions.[7] This later analysis is mandated by Section 513(a), the Regulations promulgated thereunder and the plain meaning of Section 513(c). Section 513(c) merely validated the 1967 Treasury Regulations approach to fragmenting commercial business activities of an exempt organization.[8] As properly stated by the Federal Circuit below:

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[6] Section 513(c) (1969) provides in pertinent part: [A]n activity does not lose identity as a *trade or business* merely because it is carried on within a larger aggregate of similar activities . . . which may, or may not, be related to the exempt purposes of the organzation. [Emphasis supplied.] This language has remained unchanged to the present day.

[7] The Government has apparently dropped its argument that Section 513(c) is a "more specific" provision overriding the general rule [testing for substantial relation] of Section 513(a), since this argument was properly rejected by the Federal Circuit below. To achieve the same result, the Government now argues to this Court that Example (7) and selected portions of the Committee Reports require Section 513(c) to be so read.

[8] Section 513(c) virtually repeated the language of the 1967 Treasury Regulations regarding the fragmentation concept. "Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as *trade or business* merely because they are carried on within a larger aggregate of similar activities or within a larger complex of endeavors which may, or may not, be related to the exempt purposes of an organization." [Emphasis supplied.] Reg. § 1.513-1(b), 32 Fed. Reg. 17657 (1967). Like Section 513(c), these regulations do not state that a commercial activity will not lose its identity as *an unrelated* trade or business.

> Congress made no change to the 'substantial relation' or 'convenience' tests of section 513(a). Instead, it amended the statute *only* to provide that advertising activity shall be treated as a separate trade or business for purposes of analysis. [Emphasis in original.] [9]

Both courts below correctly undertook the substantial relation analysis after considering the statutory and regulatory framework of Section 513. This approach was in accord with the approach taken by sister circuits. Considering the sale of pharmaceutical drugs by a tax-exempt hospital, both the Seventh Circuit and the Fifth Circuit recently undertook the substantial relation analysis required by Section 513(a) in deciding whether such sales were unrelated business income.[10] In *Hi-Plains Hospital, supra* n.10, the Fifth Circuit expressly rejected the Government's argument that Section 513(c) created a *per se* rule that commercial pharmaceutical sales by an exempt hospital to the public constituted unrelated business income. *Id.* at 532-533. This Court should similarly reject the Government's attempt to rewrite the unambiguous language of Section 513(c).

If Section 513(c) were read to create the blanket rule regarding advertising activities advanced by the

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[9] *American College of Physicians* v. *U.S.*, 743 F.2d 1570, 1575 (Fed. Cir. 1984).

[10] *Carle Foundation* v. *U.S.*, 611 F.2d 1192, 1196 (7th Cir.), *cert. denied*, 449 U.S. 824 (1980) and *Hi-Plains Hospital* v. *U.S.*, 670 F.2d 528, 530 (5th Cir. 1982). Pharmaceutical sales, like advertising activities, are listed as examples of activities which must be fragmented from exempt functions and treated as a separate trade or business. Treas. Reg. § 1.513-1(b), 32 Fed. Reg. 17657 (1967).

Government, then (because the Section does not distinguish between any specific type of commercial activity)[11] that Section would have to be read to create the same blanket rule for all component commercial activities of exempt organizations. How can the plain language of Section 513(c) be read to contain a *per se* rule for one commercial activity and a different rule [i.e., fragmentation only] for other commercial activities without expressly so stating?

C. The Legislative History Of Section 513(c) Does Not Support The So-Called Blanket Rule Advanced By The Government.

The Government cites selected portions of the House and Senate Reports[12] as support for its position that the language of Section 513(c) creates a blanket rule that all advertising revenues in a tax-exempt organization's publication constitute unrelated trade or business income (Gov. Brf., pp. 24-26). The Reports cannot be so read. The Committee Reports indicate that Congress, in enacting Section 513(c), was primarily concerned with validating the mechanism created in the 1967 Regulations to fragment an exempt organization's commercial activities from its exempt functions. House Report at 50. The Senate would have fragmented only three commercial activities, including advertising, but

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[11] The use of the term "advertising" in the title to Section 513 (c) does not limit the scope of the Section to advertising alone. Section 7806(b) makes clear that the title of a Code Section is not to be "given any legal effect."

[12] H.R. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. 50-51 (1969) ("House Report") and S. Rep. No. 91-552, 91st Cong., 1st Sess. 75 (1969).

its view was rejected by the Conference Committee in favor of the more general House version.[13] The Conference Committee Report merely repeated the fragmentation concept common to the House and Senate versions of the bill. Most important, however, it made no reference to any blanket rule that journal advertising revenue automatically constitutes unrelated business income.

In its Supplemental Report[14] containing a technical explanation of the 1969 Tax Reform Act, the House Ways and Means Committee again reiterated the fragmentation rule common to both versions of the bill and concluded with respect to the intent and legal effect of the fragmentation rule:

> Therefore, *for example,* the advertising contained in a publication of an exempt organization *may* be subject to tax under section 511 even though the editorial content of the publication may be related to the exempt purposes of the organization. [Emphasis supplied.]

This language does not create a blanket rule. By using the term "may", Congress affirmed the principle inherent in Section 513(c) that fragmented commercial activities must be tested for substantial relation before a finding of unrelated business income can be made. As indicated by the Fifth Circuit in *Hi-Plains Hospital,* and by the Supplemental Report, there are two questions to be addressed. First, can the activity be fragmented? Then, there is an additional, more

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[13] H.R. Rep. No. 91-782, 91st Cong., 1st Sess. 292 (1969) ("Conference Committee Report").

[14] H.R. Rep. No. 91-413 (Part 2), 91st Cong., 1st Sess. 26 (1969).

fundamental question to be answered after fragmentation: is the fragmented commercial activity substantially related to an organization's exempt purposes?

If Section 513(c) is read automatically to answer the latter question negatively regarding publication advertising activities of an exempt organization, then that Section must be read as creating two different rules for component commercial activities. The first rule, a *per se* one, would provide that publication advertising activities are automatically unrelated. The second rule would provide that other component commercial activities, e.g. a museum's sale of greeting cards to the public (Rev. Rul. 73-104, *supra*), are fragmented into a separate trade or business and are then tested for substantial relation under Section 513(a). The statute plainly does not create two different rules and cannot be so read. If it were so read, the blanket rule would have to reach not only advertising but all commercial activities conducted as one component of larger exempt activities, and the substantial relation test would be a nullity.

D. Example (7) Does Not Create A Blanket Rule That All Journal Advertising Revenue Of Exempt Organizations Is Unrelated Business Income.

Finding no support for its so-called blanket rule in the plain language of Section 513(c), the Government argues that Example (7) creates a blanket rule and that Congress intended Section 513(c) to implement this rule (Gov. Brf., p. 24). As indicated above, neither the plain language of Section 513(c) nor the Committee Reports explaining that Section justify such a construction of the statute.

The Government's argument in favor of construing Example (7) as a blanket rule is also belied by the position of the Internal Revenue Service. In Rev. Rul. 82-139, 1982-2 C.B. 108, the Revenue Service considered whether revenues received by a Section 501(c)(6) bar association from advertisements in its bar journal for products and services used by attorneys constituted unrelated business income. Although the products and services are not identified in the Ruling, the advertising in most bar journals is primarily general advertising of office products (e.g. word processing equipment), office supplies and legal books. Both Example (6) of the 1967 Regulations [15] and Example (7) would appear to be germane to the subject matter of the Ruling.

In holding that the advertising revenues were unrelated business income, the Revenue Service did not even refer to Examples (6) and (7) as a basis for the result reached. This appears to be a change of position by the Revenue Service, since Example (6) was cited by it previously in Rulings dealing with the general advertising of exempt organizations.[16]

The Revenue Service cited Section 513(c) and Treas. Reg. § 1.513-1(b) as primary support for its conclusion. Interestingly, the Revenue Service cited a portion of Treas. Reg. § 1.513-1(b) concerning the advertising fragmentation principle, but it added the word

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[15] Treas. Reg. § 1.513-1(d)(4)(iv), Example (6), 32 Fed. Reg. 17657, 17659 (1967).

[16] Rev. Rul. 76-93, 1976-1 C.B. 170; Rev. Rul. 74-38, 1974-1 C.B. 144.

unrelated to the cited passage.[17] It then bootstrapped by stating that Section 513(c) and Treas. Reg. § 1.513-1(b) required a finding that the advertising revenues were *per se* unrelated income.[18]

AAAS submits that the only explanation for the Revenue Service's changed analysis in Rev. Rul. 82-139 is its tacit acknowledgement that neither Example (6) nor Example (7) constitute blanket rules of substantive law. This concession is proper since both Examples were promulgated as part of interpretative regulations under Section 513.[19] In an attempt to bypass the substantial relation test, the Revenue Service appears to have rewritten its own regulations in Rev. Rul. 82-139 by adding the word *unrelated* to Treas. Reg. § 1.513-1(b). Since the language of that Regulation and Section 513(c) is virtually identical, the Revenue Service then attributes the word *unrelated* to Section 513(c) and concludes that both statute and regulations have created a *per se* rule that publication

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[17] In Rev. Rul. 82-139, Treas. Reg. § 1.513-1(b) is cited in pertinent part as, "[a]ctivities of . . . publishing commercial advertising do not lose their identity as *an unrelated* trade or business. . . ." [Emphasis supplied.]

Treas. Reg. § 1.513-1(b) actually reads, "[a]ctivities of . . . publishing commercial advertising do not lose identity as a *trade or business*. . . ." [Emphasis supplied.]

[18] The Government bootstraps in the same manner in its brief. For example, it cites the trade or business fragmentation principle of Section 513(c) and concludes in the next sentence that the words of Section 513(c) expressly sanctioned " 'fragmentation' of an activity into exempt-purpose and *unrelated-business* components. . . . (Gov. Brf., p. 24). [Emphasis supplied.]

[19] Prop. Treas. Reg. § 1.513-1, 32 Fed. Reg. 5993 (1967).

advertising revenue is automatically unrelated.[20] The statute and the regulations do not remotely support the Revenue Service's analysis.

This bootstrapping analysis is also necessary because Example (7) is nothing more than what its title implies—an example. It specifies a particular set of subjective facts and tests for substantial relation. If the Treasury wanted to create a blanket rule, it strains logic to argue that it would have used an example in a subsection of a subparagraph to do so. Moreover, if the so-called blanket rule in Example (7) is deemed to be that advertising selected in the manner of ordinary commercial advertising is always unrelated to an organization's exempt purposes, then the Example improperly focuses on the commerciality of the activity, rather than the relatedness of the activity to an exempt purpose. The focus on commerciality rather than relatedness violates the plain language of Section 513(a), its legislative history and Treas. Reg. § 1.513-1(b) (quoted at p. 7 above).

E. Administrative Convenience Cannot Justify Rewriting Section 513(c) To Create A Blanket Rule.

In arguing for a blanket rule that publication advertising revenues always constitute unrelated business income, the Government seeks to apply a sledgehammer to a gnat. AAAS agrees with Respondent's position that professional advertising in many exempt organi-

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[20] Compare Rev. Ruls. 73-104 and 73-105, 1973-1 C.B. 263-264, which state, "Section 513(c) of the Code and Section 1.513-1(b) of the Income Tax Regulations provide that *trade or business* includes any activity which is carried on for the production of income from the sale of goods." [Emphasis supplied.]

zation journals is not substantially related to the exempt purposes of those organizations.[21] However, Respondent has presented a case in which professional advertising has contributed importantly to an exempt educational purpose, as found by the Federal Circuit.

By creating the substantial relation test in Section 513(a), Congress intended a factual analysis to be made of whether commercial activities further an exempt purpose in testing for unrelated income. That factual test has been applied by the Revenue Service for 35 years in all areas of activities of exempt organizations without apparent adverse effect. However, now it states that the lack of a blanket rule will cause a drain on its audit resources.

Although AAAS disagrees with the Revenue Service's position, it is for Congress and Congress alone to create *per se* rules. Congress has shied away in the past from blanket rules in the exempt organization area, especially with respect to Section 501(c)(3) public charities. There is no question that most charities to some extent lessen the burdens of government. For example, Congress indicated in 1938 that one primary reason for creating tax exemption for charities was that they relieve the Government of financial burdens

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[21] In addition to publishing the very technical *Science*, AAAS also publishes a monthly scientific, educational magazine entitled *Science 85*. This sister magazine is directed to a more broad-based readership and presents scientific articles more readable and understandable by individuals not formally trained as scientists. Since the inception of this sister magazine in 1979, AAAS has treated the advertising revenues generated by *Science 85* as unrelated business income, since these advertisements are of a general consumer nature. This is in marked contrast to the educational purpose and policy of advertisements presented in *Science*.

which would otherwise have to be met using government funds.[22] The unrelated business income tax itself was implemented in part to remove the former rule that a commercial endeavor of an exempt organization justified the loss of its tax exemption.[23] In an area requiring a sensitive balancing of the broad social purposes served by charities and the legitimate interests of the Government, Congress is charged with the responsibility of creating blanket rules, if the balancing test weighs in favor of such rules. It did not do so in 1969, and Section 513(c) cannot be read to do so now to serve the Revenue Service's convenience.

CONCLUSION

AAAS has limited its analysis in this brief to whether Congress adopted a blanket rule in 1969 to tax all publication advertising revenues of all exempt organizations. Congress could have chosen to do so, but it did not and Section 513(c) cannot be so read. If it were so read, the blanket rule would reach all commercial activities conducted as one component of larger exempt activities, not just advertising, and the substantial relation test, which has existed unchanged for 35 years, would be a nullity.

Although AAAS did not brief other legal arguments raised by Respondent in support of the decision below, it is in agreement with Respondent's legal analysis, reasoning and conclusions and, hence, this Court should affirm the decision of the Federal Circuit in this case.

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[22] H.R. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1938).

[23] Hopkins, *The Law of Tax-Exempt Organizations*, § 40.1, Ronald Press (4th ed. 1983).

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